Supreme Court, U.S.
FILED
NOV 21 2007
OFFICE OF THE CLERK

No. 07-684

IN THE

Supreme Court of the United States

LIBERTY ELECTRIC POWER, LLC,

Petitioner,

v.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

MARTIN J. BIENENSTOCK
Counsel of Record
JUDY G.Z. LIU
CAITLIN J. HALLIGAN
GREGORY SILBERT
WEIL, GOTSHAL & MANGES LLP
767 Fifth Avenue
New York, New York 10153
[Tel.] (212) 310-8000
[Fax] (212) 310-8007

Attorneys for Petitioner

211843

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

QUESTION PRESENTED

In a bankruptcy case, may a federal court rely on purported equitable principles to reject a creditor's claim, where the claim is otherwise valid under state law and the creditor is not alleged to have engaged in wrongdoing or inequitable conduct?

PARTIES AND CORPORATE DISCLOSURE STATEMENT

The parties to the proceeding in the court below are as set forth in the caption of the case.[1]

Liberty is wholly owned by Liberty Electric PA II, LLC.

1. John L. Daugherty, Trustee, was incorrectly identified as an appellee in the caption of the Fourth Circuit's decision. Mr. Daugherty was not a party at any stage of this adversary proceeding, and is not a party to this petition for certiorari.

TABLE OF CONTENTS

	Page
Question Presented	i
Parties and Corporate Disclosure Statement	ii
Table of Contents	iii
Table of Appendices	v
Table of Cited Authorities	vi
Opinions Below	1
Jurisdiction	1
Statutory Provision Involved	1
Statement of the Case	2
Reasons for Granting the Petition	10
I. The Decision Below Conflicts with the Precedents of This Court and Other Federal Courts of Appeals.	12
A. The Decision Below Conflicts with the Precedents of Other Federal Courts of Appeals Regarding the Appropriate Use of Equitable Principles to Disallow Claims in Bankruptcy.	12

Contents

Page

B. The Decision Below Conflicts with the Decisions of This Court and the Lower Federal Courts Regarding the Interplay Between State Law and the Federal Law of Bankruptcy. 17

II. This Case Presents a Question of Exceptional Importance Because the Decision Below Creates Substantial Uncertainty as to When Valid State Law Claims Will Be Allowed in Bankruptcy Cases 20

Conclusion 23

TABLE OF APPENDICES

Page

Appendix A — Opinion Of The United States Court Of Appeals For The Fourth Circuit Decided July 10, 2007 ..... 1a

Appendix B — Final Order Of Judgment Of The United States District Court For The District Of Maryland Filed March 7, 2006 ..... 19a

Appendix C — Order Of The United States Bankruptcy Court For The District Of Maryland, Greenbelt Division Filed August 10, 2005 ..... 21a

Appendix D — Memorandum Of Decision Of The United States Bankruptcy Court For The District Of Maryland At Greenbelt Date Signed June 24, 2005 ..... 25a

Appendix E — Order Of The United States Court Of Appeals For The Fourth Circuit Denying Petition For Rehearing Filed August 6, 2007 ..... 38a

TABLE OF CITED AUTHORITIES

Page

CASES

Matter of A.G. Finance Serv. Ctr., Inc.,
395 F.3d 410 (7th Cir. 2005) 18

In re ASI Reactivation, Inc.,
934 F.2d 1315 (4th Cir. 1991) 14, 17

In re Ahlswede,
516 F.2d 784 (9th Cir. 1975) 14, 15

In re Baker & Getty Finance Services, Inc.,
974 F.2d 712 (6th Cir. 1992) 14, 15, 17

In re Bellanca Aircraft Corp.,
850 F.2d 1275 (8th Cir. 1988) 14

Butner v. United States,
440 U.S. 48 (1979) 18

Carrieri v. Jobs.com Inc.,
393 F.3d 508 (5th Cir. 2004) 18

In re Castletons,
990 F.2d 551 (10th Cir. 1993) 14

In re Century Inns, Inc.,
59 B.R. 507 (Bankr. S.D. Miss. 1986) 13

Cited Authorities

Page

Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982 (3d Cir. 1998) 15

In re Combustion Engineering, Inc., 391 F.3d 190 (3d Cir. 2004) 18

Comstock v. Group of Institutional Investors, 335 U.S. 211 (1948) 12

Darr v. Muratore, 8 F.3d 854 (1st Cir. 1993) 5, 16

In re Dominelli, 820 F.2d 313 (9th Cir. 1987) 14

In re Exec Tech Partners, 107 F.3d 677 (8th Cir. 1997) 18

FCC v. NextWave Personal Commc'ns Inc., 537 U.S. 293 (2003) 9

In re Four Seasons Nursing Centers of America, Inc., 483 F.2d 599 (10th Cir. 1973) 14, 15

Gaff v. Federal Deposit Insurance Corp., 919 F.2d 384 (6th Cir. 1990) 14

In re Giorgio, 862 F.2d 933 (1st Cir. 1988) 14, 17

Cited Authorities

Page

In re Hashim,
213 F.3d 1169 (9th Cir. 2000) 18

Heiser v. Woodruff,
327 U.S. 726 (1946) 12

Ivanhoe Building & Loan Association v. Orr,
295 U.S. 243 (1935) 6-7

Kapp v. Naturelle, Inc.,
611 F.2d 703 (8th Cir. 1979) 14, 15

In re Lifschultz Fast Freight,
132 F.3d 339 (7th Cir. 1997) 14, 21

In re Madeline Marie Nursing Homes,
694 F.2d 433 (6th Cir. 1982) 14, 15

Manufacturers Trust Co. v. Becker,
338 U.S. 304 (1949) 12

Mitchell v. Hampel,
276 U.S. 299 (1928) 21

In re Mobile Steel Co.,
563 F.2d 692 (5th Cir. 1977) 13, 16

Musso v. Ostashko,
468 F.3d 99 (2d Cir. 2006) 14

Cited Authorities

Page

In re Ogden,
314 F.3d 1190 (10th Cir. 2002) 18

In re Outdoor Sports Headquarters, Inc.,
168 B.R. 177 (Bankr. S.D. Ohio 1994) 13

Pepper v. Litton,
308 U.S. 295 (1939) 12

Prudence Realization Corp. v. Geist,
316 U.S. 89 (1942) 12

Raleigh v. Ill. Department of Revenue,
530 U.S. 15 (2000) 18

Sampsell v. Imperial Paper & Color Corp.,
313 U.S. 215 (1941) 12

Small v. Beverly Bank,
936 F.2d 945 (7th Cir. 1991) 14, 15

Story v. Livingston,
38 U.S. 359 (1839) 5

Taylor v. Standard Gas & Electric Co.,
306 U.S. 307 (1939) 12

Travelers Casualty & Surety Co. v. Pac. Gas & Electric Co.,
127 S. Ct. 1199 (2007) 10, 18

Cited Authorities

Page

United States ex rel. Finney v. Nextwave Telecom, Inc., 337 B.R. 479 (S.D.N.Y. 2006) 9

United States v. Noland, 517 U.S. 535 (1996) 13, 14

United States v. Pollack, 370 F.2d 79 (2d Cir. 1966) 2

Vanston Bondholders Protective Committee v. Green, 329 U.S. 156 (1946) 12

In re W.T. Grant Co., 699 F.2d 599 (2d Cir. 1983) 16

FEDERAL STATUTES

11 U.S.C. § 502(b)(2) ..... *passim*

11 U.S.C. § 502(e) 21

11 U.S.C. § 509 21

11 U.S.C. § 510(c)(1) 13

11 U.S.C. § 524(e) 8, 19

28 U.S.C. § 1254(1) 1

Page

RULES

Supreme Court Rule 10(a) 20

Supreme Court Rule 10(c) 20

MISCELLANEOUS

16 CHARLES ALAN WRIGHT, ARTHUR MILLER & EDWARD H. COOPER, FEDERAL PRACTICE AND PROCEDURE § 3926.2 (2d ed. 1996) 9

R. STERN, E. GRESSMAN, S. SHAPIRO & K. GELLER, SUPREME COURT PRACTICE, SUPREME COURT PRACTICE 196 (7th ed. 1993) 9

Liberty Electric Power LLC ("Liberty") respectfully petitions for a writ of certiorari to review a judgment of the United States Court of Appeals for the Fourth Circuit.

OPINIONS BELOW

The Court of Appeals' opinions (Appendix to the Petition ["App."] 1a-18a) are reported at 492 F.3d 297. The opinions of the district court (App. 19a-20a) and the bankruptcy court (App. 25a-37a) are not reported.

JURISDICTION

The judgment of the Court of Appeals was entered on July 10, 2007. A petition for rehearing and for rehearing en banc was denied on August 6, 2007. *See* App. 38a-39a. By order dated October 26, 2007, this Court extended the time for Liberty to file a petition for a writ of certiorari until December 5, 2007. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 502(b)(2) of the Bankruptcy Code provides that if an objection is made to a claim submitted in a bankruptcy case:

> the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that such claim is for unmatured interest.

11 U.S.C. § 502(b)(2).

STATEMENT OF THE CASE

1. At issue in this bankruptcy case is whether a federal court may rely on purported equitable principles to reject an otherwise valid claim, where there has been no inequitable conduct by the creditor. The claim rejected by the Fourth Circuit arises from a guaranty. A guaranty is an agreement requiring one entity, the guarantor or surety, to answer for the debt of another entity, the borrower or primary obligor. By making another entity jointly and severally liable for a debt, guaranties protect commercial creditors against the risk of default by the primary obligor. Moreover, guaranties enable the creditor to collect from a solvent guarantor amounts that could not be collected from the primary obligor if it were to go into bankruptcy, such as interest accruing on an unsecured debt after a bankruptcy commences. *See* 11 U.S.C. § 502(b)(2). Absent an express agreement to the contrary, a creditor is entitled under state law to allocate a payment from a guarantor first to accrued interest, and then to principal. *See United States v. Pollack*, 370 F.2d 79, 80 (2d Cir. 1966).

Liberty procured a guaranty that was capped by contract at an amount that did not satisfy the debt in full. Liberty allocated a payment under the guaranty first to interest, then principal, and sought to recover the outstanding principal from the primary obligor, which had commenced a bankruptcy case. Invoking a putative equitable authority to disallow claims, the court below disregarded Liberty's allocation of the guarantor's payment, deemed the unpaid portion of the debt to be interest rather than principal, and rejected the claim on the ground that post-bankruptcy interest on an

unsecured claim may not be collected from a debtor's estate. *See* 11 U.S.C. § 502(b)(2). The question is whether a federal court has such equitable authority, where, as here, the creditor is not alleged to have engaged in any misconduct or wrongdoing.

2. In April 2000, Liberty, an energy-generating company, entered into an agreement ("Agreement") with National Energy & Gas Transmission Energy Trading Power, L.P. ("ET Power"), under which ET Power secured the right to purchase energy from Liberty in exchange for a monthly payment. To back up ET Power's financial obligations under the Agreement, Liberty procured a limited guaranty of payment ("Guaranty") from ET Power's affiliate, Gas Transmission Northwest Corporation ("GTN"). The Guaranty provided that GTN would pay "all amounts payable by [ET Power] under the Agreement," subject to a $140 million cap. Under New York law, which governs both the Agreement and the Guaranty, "GTN was a surety for ET Power's obligations to Liberty." App. 8a.

In July 2003, ET Power commenced a voluntary case under chapter 11 of title 11 of the United States Code ("Bankruptcy Code"), and immediately rejected its Agreement with Liberty. After an arbitration to determine Liberty's damages from rejection of the Agreement, Liberty was awarded damages of $140 million — coincidentally, the same amount as the cap on GTN's guaranty liability — plus interest that continued to accrue after the filing of the bankruptcy petition. Because the Bankruptcy Code disallows claims against a debtor for interest accruing on an unsecured debt after a bankruptcy petition is filed, *see* 11 U.S.C. § 502(b)(2),

Liberty sought to recover from the bankruptcy estate only $140 million — the amount of its petition-date damages, without any subsequently accruing interest.[2]

Liberty also attempted to collect the arbitral award from ET Power's surety, GTN. Because the Agreement expressly provided that in the event of a default, ET Power would be liable for "such amount plus interest," Agreement § 14.2(c), and the Guaranty provided that GTN would be liable for "all" amounts payable by ET Power, GTN too was liable to Liberty for principal and interest, subject to the contractual cap. Liberty received $140 million pursuant to the GTN Guaranty.[3] *See* App. 4a-5a.

The $140 million payment fully satisfied GTN's capped guaranty liability, but did not fully satisfy the underlying debt as determined by the arbitral award, which, with accrued interest, had grown to approximately $157 million. The standard practice by

---

2. Liberty's total claim against ET Power's bankruptcy estate was actually higher. In addition to the debt at issue here, ET Power owed Liberty approximately $5.4 million in unpaid invoices at the time it petitioned for bankruptcy protection. In the interest of simplicity, that separate debt is ignored in this petition for certiorari, as it was in the decision below, *see* App. 4a n.2, 5a n.3, but Liberty is entitled to recoveries on that debt from the bankruptcy estate regardless of the outcome of this petition.

3. During the pendency of the arbitration, GTN, which remained solvent and never commenced a bankruptcy case, had been sold to another entity; as part of this transaction, $140 million had been reserved in escrow to provide for any liability to Liberty. Liberty received payment on the Guaranty from this escrow account. *See* App. 4a-5a, 28a & n.3.

creditors is to apply payments on a debt first to accrued interest and then, if any portion of the payment remains, to principal. *See, e.g.*, *Darr v. Muratore*, 8 F.3d 854, 861 (1st Cir. 1993) (collecting cases); *Story v. Livingston*, 38 U.S. 359, 371 (1839). Liberty did just that, allocating the first $17 million of GTN's payment to accumulated interest, and the remainder to principal. Thus, approximately $17 million of principal remained unpaid following GTN's payment.

3. After receiving partial satisfaction of the arbitral award from GTN, Liberty continued to press its claim against ET Power's bankruptcy estate. *See* App. 21a-24a. While asserting the full allowable amount of the arbitral award (*i.e.*, the full amount of petition-date damages but not the unallowable post-petition interest), Liberty acknowledged that it could collect at most $17 million, the amount of principal left unpaid after GTN's payment, since it is entitled to no more than one full satisfaction of the award from all sources.

ET Power opposed any recovery by Liberty from the bankruptcy estate, arguing that as a result of GTN's payment, Liberty's claim against the estate had been reduced to $17 million, the amount outstanding on the debt. ET Power further argued that this remaining amount must be deemed post-petition interest, not principal, and therefore must be disallowed under section 502(b)(2) of the Bankruptcy Code, which bars unsecured claims for interest accruing after a bankruptcy petition was filed. *See* App. 29a-30a. Liberty responded that its allowable claim against the estate was not reduced by GTN's partial satisfaction of the underlying debt, and that it had properly allocated GTN's payment first to interest, then to principal.

The bankruptcy court agreed with Liberty. It held that GTN, as a non-debtor guarantor, was liable for post-petition interest, and that Liberty was free to allocate GTN's $140 million payment first to the $17 million of post-petition interest and then to $123 million of principal, leaving a $17 million principal debt unpaid. *Nat'l Energy & Gas Transmission, Inc. v. Liberty Elec. Power, LLC*, No. 03-03104 (Bankr. D. Md. June 27, 2005). The district court affirmed. *Nat'l Energy & Gas Transmission, Inc. v. Liberty Elec. Power, LLC*, No. 05-2531 (D. Md. March 6, 2006).

4. A divided panel of the Fourth Circuit reversed, with three separate opinions. *Nat'l Energy & Gas Transmission*, 492 F.3d 297. The Fourth Circuit's reversal was not based on any determination that the facts found by the lower courts were clearly erroneous. Thus, all three judges on the Fourth Circuit panel acknowledged, as the lower courts had, that as against GTN, Liberty could allocate the $140 million payment first to interest and then to principal, and gave no reason to think that that this allocation would be invalid outside of bankruptcy. *See* App. 11a n.5; 13a; 18a. However, two judges ruled that under principles of equity, Liberty's allocation would be ineffective against ET Power's bankruptcy estate — and thus that the $140 million principal debt would be deemed fully paid, leaving no further allowable claim against the estate. *See* App. 12a, 13a.

The lead opinion first rejected ET Power's contention that Liberty's claim against the bankruptcy estate must be reduced in light of the payment from GTN. *See* App. 7a (citing *Ivanhoe Building & Loan Ass'n*

v. Orr, 295 U.S. 243 (1935) for the proposition that a creditor need not deduct from its claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation); App. 8a (holding that under the governing New York law, GTN's payment did not reduce the amount of ET Power's debt to Liberty).

But the majority nonetheless barred Liberty from collecting from the bankruptcy estate any of the outstanding $17 million, holding that any funds received would constitute post-petition interest disallowed by 11 U.S.C. § 502(b)(2). The lead opinion did not dispute Liberty's contractual right to allocate GTN's payment first to interest, then to principal, outside of the bankruptcy context. *See* App. 11a n.5 ("Liberty is free to classify GTN's payment as interest"). But the court concluded that for purposes of bankruptcy, "principles of equity" required it to disregard Liberty's allocation of the payment from GTN, and instead to treat the entire payment as principal and the outstanding amount as post-petition interest:

> The § 502(b)(2) bar to collection of interest is not overcome by Liberty's classification of the $17 million it now seeks as principal. . . . Because ET Power's debt was capped at $140 million by the filing of the bankruptcy petition and because the debt was increased only by the accrual of interest pursuant to the arbitration award, we view Liberty's claim for an additional $17 million as disallowed post-petition interest no matter how Liberty chooses to classify it.

App. 11a.

Although it expressly relied on "principles of equity" to reach this result, nowhere did the majority find that Liberty had engaged in any type of inequitable conduct — and indeed such a finding would have been impossible on this record, since Liberty is not even alleged to have engaged in misconduct, and no finding of misconduct was made by the district court or the bankruptcy court, both of which had permitted Liberty to collect the outstanding $17 million.

The concurring opinion noted that the lead opinion did not contest "Liberty's contractual rights under its guarantee from GTN to allocate principal and interest in any fashion it sees fit in relation to GTN." App. 13a-14a n.* (Wilson, J., concurring in the judgment). Without further explanation, however, the concurring opinion concluded that Liberty could not "allocate its way around § 502(b)(2)'s disallowance of unmatured interest." App. 13a.

The dissenting opinion objected that the majority's holding was irreconcilable with "ample authority . . . to the contrary." App. 14a. The dissent started "with the basic principle of contract law that Liberty is entitled to be paid in full, including interest, by its jointly and severally liable debtors." App. 15a. "[I]t is . . . well-settled," the dissent continued, "that § 502(b)(2) has no impact on the accrual of unmatured interest against non-debtors, including non-debtor guarantors." App. 15a (citing cases). Yet, the dissent noted, "the majority would have the bar to recovery of interest from the debtor swallow the accrual of interest on the debt across all parties liable for it." App. 16a. The dissent also cautioned that this result appeared to violate section 524(e) of the

Bankruptcy Code, which provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on ... such debt." App. 17a. Unlike the majority, the dissenting judge "fail[ed] to see the unfairness in the fact that Liberty bargained, outside of bankruptcy, for a guarantee of payment. That other creditors may not have secured such a guarantee, and therefore might ultimately recover proportionally less than Liberty, strikes me as no injustice." App. 17a.

Liberty petitioned for rehearing and rehearing en banc in July 2007. The petition was denied on August 6, 2007, with the same judge again dissenting. App. 39a.[4]

---

4. Although no final judgment has been entered in the underlying bankruptcy proceeding, that is no obstacle to this Court's review. Where, as here, a petition for certiorari presents an "important and clear-cut issue of law," R. STERN, E. GRESSMAN, S. SHAPIRO & K. GELLER, SUPREME COURT PRACTICE, SUPREME COURT PRACTICE 196 (7th ed. 1993), and the rule of law announced by the circuit court will not be altered or refined by ongoing proceedings below, then such proceedings do not affect this Court's review. Indeed, "bankruptcy proceedings justify a distinctive and more flexible definition of finality." 16 CHARLES ALAN WRIGHT, ARTHUR MILLER & EDWARD H. COOPER, FEDERAL PRACTICE AND PROCEDURE § 3926.2, at 271 (2d ed. 1996). Accordingly, this Court has not hesitated to hear bankruptcy cases even where, as here, there has not yet been a final distribution from the bankruptcy estate. *See, e.g.*, *FCC v. NextWave Pers. Commc'ns Inc.*, 537 U.S. 293 (2003) (opinion of this Court issued on 1/27/03); *United States ex rel. Finney v. Nextwave Telecom, Inc.*, 337 B.R. 479, 484 (S.D.N.Y. 2006) (stating that the reorganization plan was approved on 3/1/05).

REASONS FOR GRANTING THE PETITION

The decision below warrants this Court's review because it conflicts with prior decisions of this Court and the lower federal courts governing creditors' entitlements in bankruptcy; displaces state law in a manner that unduly disrupts rational commercial expectations; and needlessly increases the cost of credit.

The Fourth Circuit's decision creates a three-way conflict among the circuits regarding when, if at all, a federal court may rely on equitable principles to disallow an otherwise valid claim in bankruptcy. The Fifth Circuit permits only equitable subordination — not equitable disallowance — of claims, so a claim found to be inequitable will be allowed but given lower priority than other claims. Five other Circuits permit equitable disallowance of claims, but only upon a finding of fraud or other inequitable conduct by the creditor. Under the Fourth Circuit's decision, in contrast, a federal court may disallow, not merely subordinate, a claim on equitable grounds, and do so even where the creditor has engaged in no fraud or misconduct of any kind.

The decision below also conflicts with well-established precedents from this Court and at least six federal courts of appeals governing the relationship between state law and federal bankruptcy law. Just last term, in *Travelers Cas. & Surety Co. v. Pac. Gas & Elec. Co.*, 127 S. Ct. 1199 (2007), this Court reiterated that a claim that is valid under state law is allowable in bankruptcy unless the Bankruptcy Code expressly disallows it. Outside bankruptcy, Liberty was concededly entitled to allocate its $140 million payment from GTN

first to $17 million of interest and then to $123 million of principal, leaving $17 million of principal unpaid. But the Fourth Circuit created a new bankruptcy rule disregarding Liberty's valid state law allocation and deeming the unpaid portion of the claim unallowable interest, despite the absence of any explicit directive in the Bankruptcy Code requiring this result.

In addition, review of the decision below is imperative because of its adverse impact on the commercial credit market. The Fourth Circuit's reliance on a muddled equitable calculus to override Liberty's allocation of its guaranty payment will bring substantial uncertainty to the well-settled rights of creditors, debtors, and their guarantors in bankruptcy cases. Because this uncertainty undermines the value of commercial guaranties, it inevitably will raise the cost of credit, making credit less available. It thus presents a question of exceptional importance meriting this Court's attention.

I. The Decision Below Conflicts with the Precedents of This Court and Other Federal Courts of Appeals.

A. The Decision Below Conflicts with the Precedents of Other Federal Courts of Appeals Regarding the Appropriate Use of Equitable Principles to Disallow Claims in Bankruptcy.

The Fourth Circuit relied on "principles of equity" to reject Liberty's claim against ET Power to collect $17 million of unpaid principal — a claim that was concededly valid under applicable non-bankruptcy law — but made no finding that Liberty had engaged in inequitable conduct. *See* App. 9a-10a. Because six other courts of appeals have held that a court's equitable powers may not override a creditor's valid state law entitlement in those circumstances, the Fourth Circuit's decision creates an irreconcilable conflict that must be resolved by this Court.

This Court recognized more than six decades ago that "the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy [may] require[] its subordination to other claims which, in other respects, are of the same class." *Prudence Realization Corp. v. Geist*, 316 U.S. 89, 95 (1942); *see also Mfrs. Trust Co. v. Becker*, 338 U.S. 304, 310-14 & n.7 (1949); *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 228-31 (1948); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 162-67 (1946); *Heiser v. Woodruff*, 327 U.S. 726, 732 (1946); *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219-20 (1941); *Pepper v. Litton*, 308 U.S. 295, 303-11 (1939); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 322-23 (1939).

Even before the Fourth Circuit's decision, the lower federal courts were in disagreement as to whether courts

sitting in bankruptcy may rely on principles of equity to disallow, rather than merely subordinate, an otherwise valid claim. *See In re Outdoor Sports Headquarters, Inc.*, 168 B.R. 177, 181 (Bankr. S.D. Ohio 1994) ("Conflicting federal case law exists on the issue of whether a claim may be disallowed upon equitable principles."). The Fifth Circuit has taken the most restrictive view of the sweep of these equitable powers. In *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977), the Fifth Circuit identified "two principal bounds" on a federal court's equitable authority in bankruptcy cases. *Id.* at 699. First, under the Fifth Circuit's rule, "equitable considerations can justify only the subordination of claims, not their disallowance." [5] *Id.*; *see also In re Century Inns, Inc.*, 59 B.R. 507 (Bankr. S.D. Miss. 1986); 11 U.S.C. § 510(c)(1) (expressly providing that claims may be subordinated "under principles of equitable subordination," but not providing for equitable disallowance). Second, the Fifth Circuit held that "before exercise of the power of equitable subordination is appropriate," the "claimant must have engaged in some type of inequitable conduct." [6] 563 F.2d at 699-700.

5. The holder of a disallowed claim is entitled to no distributions from the bankruptcy estate under any circumstance. The holder of a subordinated claim is entitled to distributions, but only after creditors with claims of a higher priority have been paid in full.

6. In *Mobile Steel*, the Fifth Circuit imposed two further conditions on equitable subordination: the claimant's misconduct must have injured creditors or given the claimant an unfair advantage, and subordination of the claim must be consistent with the governing statute. 563 F.2d at 700. "This last requirement," this Court observed, "has been read as a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." *United States v. Noland*, 517 U.S. 535, 539 (1996) (internal quotation marks omitted).

Nearly every other court of appeals — including the Fourth Circuit — has agreed with this second holding, requiring a showing of misconduct by a creditor before equitably subordinating the creditor's claim. *See In re Giorgio*, 862 F.2d 933, 938 (1st Cir. 1988) (Breyer, J.); *Musso v. Ostashko*, 468 F.3d 99, 108-09 (2d Cir. 2006); *In re ASI Reactivation, Inc.*, 934 F.2d 1315, 1321 (4th Cir. 1991); *In re Baker & Getty Fin. Servs., Inc.*, 974 F.2d 712, 717-18 (6th Cir. 1992); *In re Lifschultz Fast Freight*, 132 F.3d 339, 344 (7th Cir. 1997); *In re Bellanca Aircraft Corp.*, 850 F.2d 1275, 1282 (8th Cir. 1988); *In re Dominelli*, 820 F.2d 313, 318-19 (9th Cir. 1987); *In re Castletons*, 990 F.2d 551, 559 (10th Cir. 1993). This Court has recognized but expressly declined to reach the question "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated." *United States v. Noland*, 517 U.S. 535, 543 (1996).

Five courts of appeals permit not only equitable subordination, as the Fifth Circuit does, but equitable disallowance as well. *See In re Madeline Marie Nursing Homes*, 694 F.2d 433, 437 (6th Cir. 1982); *Small v. Beverly Bank*, 936 F.2d 945, 949 (7th Cir. 1991); *Kapp v. Naturelle, Inc.*, 611 F.2d 703, 708 (8th Cir. 1979); *In re Ahlswede*, 516 F.2d 784, 787 (9th Cir. 1975); *In re Four Seasons Nursing Centers of Am., Inc.*, 483 F.2d 599, 602-03 (10th Cir. 1973). *But see Gaff v. Fed. Deposit Ins. Corp.*, 919 F.2d 384, 393 (6th Cir. 1990) (agreeing in dicta with the Fifth Circuit's position that equity "does not disallow the claim, but only subordinates it within the entire set of priorities"). The Second Circuit has suggested in dicta that it, too, would permit the disallowance of otherwise valid claims on equitable grounds alone. *See Musso*, 468

F.3d at 108. The Third Circuit has identified but declined to answer the question. *See Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 991 n.7 (3d Cir. 1998) ("We find it unnecessary here to resolve the issue as to whether equitable 'disallowance' remains an available remedy.").

The Seventh, Eighth, Ninth and Tenth Circuits have explicitly stated that equitable disallowance, like equitable subordination, is available only in cases involving inequitable conduct, such as fraud or other bad faith acts, by the creditor. *See Small*, 936 F.2d at 949 ("a particular claim may be disallowed or subordinated because of the fraudulent nature of the claim, or because of the bad faith or improper conduct by claimant"); *Kapp*, 611 F.2d at 708 ("a claim which has been reduced to judgment" can be equitably disallowed in bankruptcy if "the judgment was procured by fraud or collusion"); *In re Ahlswede*, 516 F.2d at 787 ("[a] supposed inequity resulting when an innocent party in good faith asserts a legally valid claim will not" support an equitable disallowance); *In re Four Seasons Nursing Centers*, 483 F.2d 599, 603 (10th Cir. 1973) ("Merely because a court may be exercising equitable powers [in a bankruptcy case] does not permit it to change the terms of a contract in the absence of fraud, accident or mistake."). The Sixth Circuit appears to have adopted the same limitation, since it treats equitable subordination and equitable disallowance as a uniform doctrine, *see Madeline Marie Nursing Homes*, 694 F.2d at 437 & n.6, and expressly requires creditor misconduct for equitable subordination, *see Baker & Getty Fin. Servs.*, 974 F.2d at 717-18.

The Fourth Circuit's decision below creates a three-way split among the federal courts of appeals over the scope of equitable powers in bankruptcy. In relying on equitable grounds to disallow, not merely subordinate, Liberty's claim to collect $17 million of unpaid principal, the decision below conflicts with the Fifth Circuit's rule that "equitable considerations can justify only the subordination of claims." *Mobile Steel*, 563 F.2d at 699. It also conflicts with the rule set forth by the five circuit courts that permit equitable disallowance of claims only upon a showing of fraud or other inequitable conduct. The Fourth Circuit never found that Liberty had engaged in any fraud or other improper conduct, nor would such a finding have been possible on this record. It is undisputed that the relevant agreements giving rise to Liberty's right to payment were negotiated at arms length, and even the Fourth Circuit acknowledged that Liberty had the right under state law to allocate GTN's payment to interest first, *see* App. 11a n.5, leaving a $17 million principal debt unpaid. "[T]he normal rule throughout the nation is that, absent an express agreement to the contrary, there is a presumption that loan payments are made to interest first and then principal." *Darr*, 8 F.3d at 861. That Liberty followed this "normal rule" was in no way improper or untoward. *See In re W.T. Grant Co.*, 699 F.2d 599, 609 (2d Cir. 1983) ("a creditor is under no fiduciary obligation to its debtor or to other creditors of the debtor in the collection of its claim") (internal quotation marks omitted).

One consequence of the decision below is that, in the Fourth Circuit, a creditor's claim now may be disallowed entirely under circumstances that, in all other jurisdictions, would not even warrant the lesser remedy

of subordination. Where, as here, the creditor is not an insider of the debtor, courts generally require a showing of egregious creditor misconduct before equitably subordinating a claim. *See In re Giorgio*, 862 F.2d at 939 ("Where a bankruptcy court has subordinated the debt of a creditor who was not an insider, it has done so on the ground that [the creditor's] conduct was egregious and severely unfair in relation to other creditors.") (Breyer, J.); *Baker & Getty*, 974 F.2d at 718 ("Where the claimant is a non-insider, egregious conduct must be proven with particularity" before the claim can be equitably subordinated); *id.* (the objectant "must prove that the claimant is guilty of gross misconduct"). Indeed, even in the Fourth Circuit, a claim cannot be equitably subordinated — *i.e.*, given a lower priority — unless the objectant establishes that "the claimant engaged in fraudulent conduct." *ASI Reactivation*, 934 F.2d at 1321. Yet, under the decision below, the same creditor may have its claim rejected altogether in the Fourth Circuit in the absence of any misconduct at all. This irreconcilable conflict among the circuit courts on an issue of substantial importance for commercial dealings merits resolution by this Court.

B. The Decision Below Conflicts with the Decisions of This Court and the Lower Federal Courts Regarding the Interplay Between State Law and the Federal Law of Bankruptcy.

The Fourth Circuit's novel and broad formulation of the equitable disallowance doctrine places it in conflict not just with the circuits that have addressed the scope of a bankruptcy court's equitable powers, but also with the decisions of this Court and the lower federal courts

holding that a claim which is valid under state law must be allowed in bankruptcy unless the Bankruptcy Code expressly disallows it. Earlier this year, this Court reaffirmed that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Travelers*, 127 S. Ct. at 1206. Other decisions from this Court are to the same effect. *See Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 20 (2000) ("The 'basic federal rule' in bankruptcy is that state law governs the substance of claims"); *Butner v. United States*, 440 U.S. 48, 57 (1979) (same).

Six federal courts of appeals have likewise held that "[a]bsent an overriding federal law, the existence and magnitude of valid claims against a debtor are determined by state law." *In re Exec Tech Partners*, 107 F.3d 677, 680 (8th Cir. 1997); *see also In re Combustion Eng'g, Inc.*, 391 F.3d 190, 245 n.66 (3d Cir. 2004) ("To determine whether claims are enforceable for bankruptcy purposes, § 502 relies upon applicable non-bankruptcy law."); *Carrieri v. Jobs.com Inc.*, 393 F.3d 508, 529 (5th Cir. 2004) ("the validity of a creditor's claims . . . is to be determined by reference to state law") (internal quotation marks omitted); *Matter of A.G. Fin. Serv. Ctr., Inc.*, 395 F.3d 410, 413-14 (7th Cir. 2005) ("Bankruptcy law enforces non-bankruptcy entitlements, unless they are modified according to the Code. Bankruptcy courts lack authority to alter rules of state law, or depart from those in the Code, to implement their own views of wise policy.") (internal citation omitted); *In re Hashim*, 213 F.3d 1169, 1171 (9th Cir. 2000) ("The validity of a creditor's claim against the bankruptcy estate is governed by . . . state law"); *In re Ogden*, 314 F.3d 1190, 1200 (10th Cir. 2002) ("non-bankruptcy substantive law usually determines the existence of a claim").

The Fourth Circuit identified no factor, such as fraud, that might have rendered Liberty's claim for payment of unpaid principal invalid under state law. To the contrary, the court acknowledged Liberty's right outside of bankruptcy to allocate GTN's payment to interest first, leaving $17 million of principal unpaid. *See* App. 11a n.5; App. 12a. The court below also did not identify any provision of the Bankruptcy Code that expressly required it to disregard Liberty's allocation of GTN's payment and to disallow Liberty's claim. The sole provision relied on by the majority merely disallows claims for "unmatured interest." *See* App. 8a-13a (applying 11 U.S.C. § 502(b)(2)). Nowhere does it expressly provide that a creditor's exercise of its contractual right to allocate a guarantor's payment to interest must be set aside by the bankruptcy court. *See* App. 16a ("There is simply nothing in the Bankruptcy Code, applicable case law, the relevant guarantee agreement, or nonbankruptcy law to support the jettisoning of basic contract law principles in favor of an expansive reading of § 502(b)(2).") (Duncan, J., dissenting). Indeed, the most pertinent provision of the Bankruptcy Code would seem to prohibit the Fourth Circuit's equitable re-characterization of GTN's payment as one for principal, instead of interest. Section 524(e) provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on . . . such debt." 11 U.S.C. § 524(e). By allowing a bankruptcy filing to alter Liberty's allocation of its payment from GTN, the majority's holding "appears to expressly violate" this provision. App. 17a (Duncan, J., dissenting).

The Fourth Circuit's disregard of Liberty's state law rights against its debtor, ET Power, is in direct conflict with the approach adopted by this Court and numerous circuit courts. Accordingly, a grant of certiorari is warranted.

II. This Case Presents a Question of Exceptional Importance Because the Decision Below Creates Substantial Uncertainty as to When Valid State Law Claims Will Be Allowed in Bankruptcy Cases

If the Fourth Circuit's decision is left intact, creditors will be unable to predict when their valid state law claims will be allowed in bankruptcy. This uncertainty inevitably will impair the market for commercial credit — a significant consequence implicating the health of the national economy. This case therefore presents an issue of exceptional importance meriting this Court's review. *See* Sup. Ct. R. 10(a),(c).

In its narrowest application, the decision below undermines the value of guaranties, which are a standard form of credit enhancement in commercial finance. Guaranties help not only lenders, by allowing them to mitigate more effectively the risks of default and insolvency, but borrowers as well. Entities with less than triple A credit ratings may be able to obtain loans only when the lender can procure a guaranty. Similarly, guaranties reduce the cost of credit because they lower the risk of loss. Interest is, of course, an essential component of credit because lenders cannot afford to lend money for no return.

More broadly, the Fourth Circuit's decision casts a cloud over any claim that, despite the absence of misconduct by the creditor, could be perceived as "inequitable" by a federal judge. Here, the Fourth Circuit disallowed Liberty's claim because it (wrongly) believed that doing so would free up funds for other

creditors, which it thought would be a fair result.[7] *But see* App. 17a ("I fail to see the unfairness in the fact that Liberty bargained, outside of bankruptcy, for a guarantee of payment.") (Duncan, J., dissenting); *Mitchell v. Hampel*, 276 U.S. 299, 302 (1928) ("The only real equity is not to disturb the equilibrium established by the parties. Those who take less security have no claim to be put on a footing with those who require more."). If the decision below stands, other creditors with valid state law claims asserted in good faith could similarly be turned away. The resulting uncertainty will drive up the cost of credit, making credit less available. As the Seventh Circuit observed in a case involving equitable subordination, "[i]f a court wrongly subordinates a claim, other investors are sure to take heed. An investor will see that the chance she might not get her money back has gone up slightly. She will be less willing to lend or invest in the future; and the cost of credit will rise for all." *Lifschultz Fast Freight*, 132 F.3d at 347. The Fourth Circuit's rule will turn bankruptcy reorganization into an unpredictable playground, where creditors' recoveries depend on a judge's personal sense of equity instead of on a contractual or other right to payment established by non-bankruptcy law. That is not a fair or efficient system for distributing an insolvent company's assets and liabilities.

---

7. The Fourth Circuit was incorrect in this supposition because it failed to account for GTN's rights of indemnity and subrogation. Denying Liberty the $17 million of unpaid principal makes more funds available not to other creditors of ET Power's bankruptcy estate, but to GTN (or its successor in interest), who ultimately can collect by way of indemnity or subrogation the distributions that would have been paid to Liberty. *See* 11 U.S.C. §§ 502(e), 509.

Moreover, the Fourth Circuit's decision leads to absurd consequences. Under the Fourth Circuit's rule, the sequence in which a creditor seeks payment from a debtor and guarantor may dictate the amount of recovery. Here, it is all but certain that had Liberty first recovered from the bankruptcy estate, it then could have proceeded against GTN for any outstanding principal *and interest*. If the bankruptcy estate paid before GTN, no one could argue that Liberty's $140 million claim — the amount of its arbitral award, less interest — represented anything but petition-date damages. Thus, the post-petition interest bar plainly would not apply, and would in no way diminish Liberty's pro rata distributions on its $140 million claim. After those distributions, any unpaid principal and interest could then have been collected from GTN, which was contractually liable for such amounts under the Guaranty. So had Liberty first collected distributions from the bankruptcy estate and only then collected the balance from GTN, it would have recovered the entire debt — principal and interest. However, since GTN made its payment before any distributions were made from the estate, Liberty was denied a full recovery under the lower court's holding. A rule under which the sequence of collection determines the amount of recovery is an absurdity that cannot stand.

CONCLUSION

For the foregoing reasons, this Court should grant the petition for certiorari to the Fourth Circuit.

Respectfully submitted,

MARTIN J. BIENENSTOCK
Counsel of Record
JUDY G.Z. LIU
CAITLIN J. HALLIGAN
GREGORY SILBERT
WEIL, GOTSHAL & MANGES LLP
767 Fifth Avenue
New York, New York 10153
[Tel.] (212) 310-8000
[Fax] (212) 310-8007

Attorneys for Petitioner

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DECIDED JULY 10, 2007

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 06-1459

In Re: NATIONAL ENERGY & GAS TRANSMISSION, INCORPORATED, formerly known as PG&E National Energy Group, Inc.,

Debtor.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT Energy Trading Power, L.P. (f/k/a PG&E Energy Trading Power, L.P.),

Plaintiffs-Appellants,

and

GAS TRANSMISSION NORTHWEST CORPORATION,

Plaintiff,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant-Appellee,

JOHN L. DAUGHERTY, Trustee,

Trustee-Appellee.

Appendix A

Argued: March 13, 2007

Decided: July 10, 2007

OPINION

SHEDD, Circuit Judge.

In this bankruptcy appeal, we must decide whether a creditor may allocate a payment made by a non-debtor guarantor first to interest then to principal, thus preserving the unpaid principal for collection in bankruptcy. Because we find that the allocation of a payment in this manner would permit the creditor to collect an amount otherwise disallowed as post-petition interest, we reverse the judgment of the district court which permitted collection of the additional amount.

I

National Energy & Gas Transmission Energy Trading Power, L.P. ("ET Power"), a debtor here, previously operated as an energy marketing and trading company. As such, it bought and sold electric power, natural gas, coal, and other physical energy commodities. ET Power also engaged in energy-based financial and hedging transactions such as future contracts, swaps, options, and derivatives. As part of its regular course of business, ET Power entered into an electricity tolling agreement (the "Agreement") with Liberty Electric Power, LLC ("Liberty"), an energy-generating company. Under the Agreement, ET Power obtained an option to purchase energy from Liberty in return for a monthly

payment to Liberty as well as certain other variable costs based on the actual amount of energy which ET Power purchased. In essence, this permitted ET Power to provide natural gas necessary to generate electricity and then to purchase the electricity which was generated.

To back up its agreement with ET Power, Liberty obtained two guarantees: one from National Energy & Gas Transmission, Inc. ("NEGT"), ET Power's corporate parent (and also a debtor in this bankruptcy); and one from Gas Transmission Northwest Corporation ("GTN"), a subsidiary of NEGT (and a non-debtor). Each guarantee contained the same terms, and in each the respective guarantor guaranteed:

> [A]s primary obligor and not merely as surety, the prompt payment when due, in accordance with the terms of the Agreement, of all amounts payable by [ET Power] under the Agreement . . . including . . . Termination Payment . . . and damage awards arising by reason of [ET Power's] breach of its performance obligations under the Agreement or otherwise.

J.A. 98. Each guarantor's liability was capped at $140 million.

On July 8, 2003, NEGT, ET Power, and other debtors filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code and a motion seeking to reject the

Agreement.[1] After ET Power and Liberty consented, the bankruptcy court granted the motion rejecting the Agreement. As a result of the rejection, Liberty sought $140 million as a termination payment and approximately $5.4 million in unpaid invoices. Liberty's claim for $140 million proceeded to arbitration pursuant to the terms of the Agreement, and an arbitration panel awarded Liberty the full $140 million plus interest accruing from the date of the Agreement's rejection and continuing subsequent to the arbitration award.[2]

During the pendency of the arbitration proceedings, NEGT agreed to sell GTN to TransCanada Corporation. As part of the transaction, $140 million was reserved in escrow to provide for any liability to Liberty under the guarantee. After the arbitration award, the dispute between Liberty and the debtors shifted back to the bankruptcy court, while interest continued to accrue on the $140 million arbitration award. To stop the accrual of interest, which had reached approximately $17 million, the parties agreed that Liberty should receive immediate

1. As the remaining debtors are not parties to this appeal, we refer herein to NEGT and ET Power as "the debtors." However, we note that the bankruptcy court denied Liberty's claim against NEGT, and Liberty does not appeal this denial.

2. The debtors stipulated to the amounts owed pursuant to the unpaid invoices, and these claims were not submitted to the arbitration panel. Both the bankruptcy court and the district court allowed a claim for these debts in the amount of $5,428,046, and the debtors do not contest this claim on appeal. Thus, in reversing the district court's order, we do not reverse the allowance of this claim.

payment of the amount held in escrow after the GTN sale, and the bankruptcy court approved this disbursal. Accordingly, Liberty was paid $140 million from the GTN sale escrow in full and final satisfaction of the GTN guarantee.

Upon receipt of payment from GTN, Liberty allocated the $140 million first to interest, then to principal. Meanwhile, Liberty continued to assert claims in bankruptcy against NEGT and ET Power for $140 million each.[3] Liberty reasoned that it could continue to assert the full value of the award against the debtors, notwithstanding the fact that it had already received payment of $140 million from GTN, because the debtors remained jointly and severally liable until it received full payment of the total debt. At the same time, Liberty recognized that it could not collect more than the approximately $17 million needed to make it whole on ET Power's debt. In seeking this amount, Liberty contended that the amount did not represent disallowed post-petition interest but rather unpaid principal—the interest portion of the award having been paid by GTN.

3. Liberty set forth ET Power's approximate liabilities as: $140 million in principal, $5.4 million in unpaid invoices, $16.8 million in interest on the principal and invoice amounts, and $3.7 million in collection costs and fees. Liberty recognized that it could not collect the $16.8 million in interest from the debtors, and the invoice amount and collection costs and fees are not at issue in this appeal. For simplicity, we focus on the $140 million at issue here. Likewise, we recognize that Liberty actually seeks to collect approximately $22 million from the estate but that approximately $5 million of this amount (the unpaid invoices) is not at issue. Thus, again for simplicity, we refer herein to the additional $17 million which Liberty seeks and which is now at issue.

The debtors objected to Liberty's claims, arguing that the $17 million which Liberty sought to collect had to constitute post-petition interest because Liberty had already received $140 million from GTN. Additionally, the debtors maintained that Liberty should not be permitted to assert a claim for $140 million when it had received $140 million and currently was owed only an additional $17 million. Otherwise, the judgment would not accurately reflect what Liberty was owed.

The bankruptcy court agreed with Liberty's position, allowing the claim for $140 million against ET Power but providing that the "maximum amount of distribution payable to Liberty" would be limited to the additional $17 million which it seeks to collect. J.A. 322. On appeal to the district court, the bankruptcy court order was affirmed. The debtors once again appeal. Because this appeal presents only questions of law, our review is de novo. *In re Bunker*, 312 F.3d 145, 150 (4th Cir.2002).

II

A.

We initially consider the debtors' contention that the value of Liberty's claim must be reduced by the $140 million it received from GTN in order to reflect accurately the amount currently owed to Liberty. Because Liberty is currently owed only approximately $17 million, the debtors argue its claim should be limited to this amount.

The debtors' argument is foreclosed by the combination of *Ivanhoe Building & Loan Ass'n of Newark v. Orr*, 295 U.S. 243, 55 S.Ct. 685, 79 L.Ed. 1419 (1935), and New York law, which governs pursuant to the Agreement. In *Ivanhoe*, the Supreme Court held that a creditor need not deduct from his claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation. Thus, as a matter of bankruptcy law, ET Power's debt to Liberty is not reduced by the amount which Liberty received from GTN. However, this merely leads to the question of what the value of ET Power's debt is, and New York law provides the answer to this question. *See Travelers Cas. & Sur. Co. of America v. Pacific Gas & Elec. Co.*, __ U.S. __, 127 S.Ct. 1199, 1205, 167 L.Ed.2d 178 (2007) ("[W]e have long recognized that the basic federal rule in bankruptcy is that state law governs the substance of claims [.]") (internal punctuation omitted).

New York law provides:

> The amount or value of any consideration received by the obligee from one or more of several obligors, or from one or more of joint, or of joint and several obligors, in whole or in partial satisfaction of their obligations, shall be credited to the extent of the amount received on the obligations of all co-obligors to whom the obligor or obligors giving the consideration did not stand in the relation of a surety.

N.Y. Gen. Oblig. L. § 15-103. Under this statute, whether GTN's payment to Liberty must be deducted from ET Power's obligation turns on whether GTN was a surety or a co-obligor.

In *Chemical Bank v. Meltzer*, 93 N.Y.2d 296, 690 N.Y.S.2d 489, 712 N.E.2d 656 (1999), the New York Court of Appeals concluded that the relationship between the guarantor and the primary obligor must determine the guarantor's status as a co-obligor or a surety, notwithstanding language in the contract purporting to render the guarantor a co-obligor. Using this approach, the court found that a suretyship existed. The relationship between ET Power and GTN is nearly identical to that of the guarantor and primary obligor in *Meltzer*. Therefore, we conclude that, despite language in the guarantee purporting to make GTN a co-obligor, GTN was a surety for ET Power's obligations to Liberty. Accordingly, the value of ET Power's debt to Liberty under state law is not reduced by the $140 million received from GTN.

B.

We next turn to the more fundamental question presented by this appeal: whether the Bankruptcy Code bars Liberty from collecting the $17 million it now seeks. Section 502(b)(2) of the Code provides that a claim shall not be allowed "to the extent that . . . [it] is for unmatured interest[.]" 11 U.S.C. § 502(b)(2). The purpose of this section is two-fold: (1) the avoidance of unfairness among competing creditors, and (2) the avoidance of

administrative inconvenience. *Bruning v. United States*, 376 U.S. 358, 362, 84 S.Ct. 906, 11 L.Ed.2d 772 (1964). As with all sections of the Code, § 502(b)(2) exists to guide the court in the administration of a bankruptcy estate so "as to bring about a ratable distribution of assets among the bankrupt's creditors." *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 161, 67 S.Ct. 237, 91 L.Ed. 162 (1946); *see also In re A.H. Robins Co., Inc.*, 972 F.2d 77, 82 (4th Cir.1992) (noting that bankruptcy court possesses "broad equity powers"). Indeed, § 502(b)(2) itself reflects the equitable nature of the Code, and our application of its bar on post-petition interest is to be guided by principles of equity. *Vanston Bondholders*, 329 U.S. at 165, 67 S.Ct. 237 ("It is manifest that the touchstone of each decision on allowance of interest in bankruptcy ... has been a balance of equities between creditor and creditor or between creditors and the debtor."). Thus, in applying § 502(b)(2), we have a duty to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." *Smith v. Robinson*, 343 F.2d 793, 801 (4th Cir.1965).[4]

In this case, Liberty seeks to collect $17 million from ET Power notwithstanding the fact that it has already received the full value—$140 million—of the debt which it was owed by ET Power on the petition date. In so doing, Liberty classifies the additional $17 million which

4. The Bankruptcy Code, of course, provides parameters within which courts must exercise their equitable powers in administering an estate. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988).

it seeks as unpaid principal. It reaches this result by applying GTN's payment of $140 million first to interest then to principal. Therefore, Liberty maintains that it is coming into bankruptcy to assert a claim for, and to collect only the remaining portion of, the $140 million which it was owed as of the petition date.

We believe that § 502(b)(2) prevents Liberty from collecting the additional $17 million it seeks despite Liberty's classification of that amount as principal. On the date the debtors filed their bankruptcy petition, the Agreement was effectively rejected and Liberty sustained damages, although the value of the damages was then unknown and disputed. Subsequently, through arbitration, Liberty's damages were determined to be $140 million. Thus, Liberty's damages and ET Power's debt to Liberty on the petition date was $140 million, and by the terms of § 502(b)(2), Liberty could not collect in bankruptcy any additional amounts added due to the accrual of interest. *Nicholas v. United States*, 384 U.S. 678, 682, 86 S.Ct. 1674, 16 L.Ed.2d 853 (1966) ("[T]he accumulation of interest on claims against a bankrupt estate is suspended as of the date the petition in bankruptcy is filed."). This result is not altered simply because Liberty holds a guarantee from a non-debtor third party. Accordingly, the arbitration panel's award of interest on the $140 million in damages, while perhaps appropriate under the Agreement and as a matter of non-bankruptcy law, is not collectable from the debtors in bankruptcy by virtue of § 502(b)(2).

Appendix A

The § 502(b)(2) bar to collection of interest is not overcome by Liberty's classification of the $17 million it now seeks as principal. Regardless of how Liberty classifies GTN's payment for its own purposes, we must "sift the circumstances surrounding" the claim to determine the reality of the transaction for purposes of the bankruptcy proceeding. *Smith*, 343 F.2d at 801. Because ET Power's debt was capped at $140 million by the filing of the bankruptcy petition and because the debt was increased only by the accrual of interest pursuant to the arbitration award, we view Liberty's claim for an additional $17 million as disallowed post-petition interest no matter how Liberty chooses to classify it.[5]

A contrary result would permit Liberty, or any other creditor, to classify a payment on a debt from a non-debtor guarantor as non-principal, thus preserving the

---

5. Liberty claims that we must accept its classification of GTN's payment as interest rather than as principal because bankruptcy proceedings cannot affect the liability of a non-debtor on a debt. *See, e.g., In re Stoller's, Inc.*, 93 B.R. 628, 635-36 (Bankr.N.D.Ind.1988) (finding that guarantors remained liable for post-petition interest as allowed by terms of guarantee). Thus, Liberty argues that preventing it from collecting the additional $17 million it seeks will essentially relieve GTN of its obligation to pay interest. We disagree. Liberty is free to classify GTN's payment as interest or to pursue collection from GTN at any time. Any limitation of Liberty's right to recover from GTN the full amount it is owed is due to the terms of GTN's guarantee or to non-bankruptcy law, not to our decision here. We merely hold that Liberty may not affect the rights of a party in bankruptcy by its classification of a payment received from a non-debtor guarantor.

full value of the principal for collection in bankruptcy. If, for example, Liberty had classified GTN's payment of $140 million not as a payment on the debt but as consideration received in return for a covenant not to sue, we would certainly look behind the transaction and would not allow collection as principal of the full $140 million. We must likewise look behind Liberty's claim here to find that the claim really constitutes post-petition interest disguised as unpaid principal.

Our construction of Liberty's claim is reinforced by the policy interests represented by § 502(b)(2). As we noted earlier, the general purpose of § 502 is "to ensure the fair allocation of assets between creditors[.]" *In re Kielisch*, 258 F.3d 315, 325 (4th Cir.2001). Thus, in cases where the allowance of post-petition interest will not result in administrative inconvenience or unfairness to creditors, post-petition interest may be allowed. *See, e.g., United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 246, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989) (noting pre-Bankruptcy Code rule permitting the award of post-petition interest where estate is solvent); *Ford Motor Credit Co. v. Dobbins*, 35 F.3d 860, 869 (4th Cir.1994) (referring to rule permitting an over-secured creditor to collect interest to the extent of his over-security). In contrast, allowing Liberty to collect the additional amount it seeks *will* have an impact on ET Power's creditors: namely, the loss of $17 million from the estate which would otherwise be available for distribution. This being so, the purpose of § 502(b)(2) is best served by barring Liberty's collection of an additional $17 million from the estate.

III

For these reasons, we conclude that § 502(b)(2) prevents Liberty from collecting the additional $17 million which it seeks from the estate. Accordingly, we reverse the judgment of the district court and remand for further proceedings consistent with this opinion. In so doing, we do not reverse the allowance of Liberty's claim for unpaid invoices, which is not before us in this appeal.

REVERSED

WILSON, District Judge, concurring in the judgment:

As I view it, the overarching issue in this appeal is reduced to this: does Liberty's contractual right with GTN, a third party, to allocate principal and interest, that is, to call payments from that guarantor what it wants to call them, preclude the Bankruptcy Court from calling those payments what they are vis-à-vis the bankrupt debtor. That is, can Liberty allocate its way around § 502(b)(2)'s disallowance of unmatured interest. In my view to do so is to simply call a rose by another name.* Accordingly, I concur in the judgment.

---

* Two preliminary observations simplify the playing field for me. First, I do not believe that Judge Shedd's opinion challenges Liberty's contractual rights under its guarantee from GTN to allocate principal and interest in any fashion it sees fit in relation to GTN. Second, we are not compelled to explore Liberty's right to recover from NEGT under NEGT's guarantee

(Cont'd)

Appendix A

DUNCAN, Circuit Judge, dissenting:

As the bankruptcy court succinctly stated in an order summarily affirmed by the district court, the debtors here proffer no authority "for the proposition that a *non-debtor* guarantor is exempt from liability to pay interest accruing after the petition date of the debtor-primary obligor" under 11 U.S.C. § 502(b)(2). *Nat'l Energy & Gas Transmission, Inc. v. Liberty Elec. Power, LLC (In re Nat'l Energy & Gas Transmission, Inc.)*, No. 03-03104, at *6 (Bankr.D. Md. June 27, 2005) (emphasis added). Because the majority advances no support for its conclusion that bankruptcy law governs the contractual relationship between a creditor and a non-debtor guarantor—and ample authority exists to the contrary—I respectfully dissent.

As the majority explains, an arbitration panel awarded Liberty $140 million plus approximately $17 million in interest accrued after the debtors' bankruptcy petition had been filed. Liberty collected $140 million from GTN, which was the maximum amount for which GTN could be liable under the terms of its guarantee. Liberty characterized GTN's payment as first, a payment of the $17 million interest, and next, a payment of part of the $140 million principal.

(Cont'd)

because the Bankruptcy Court disallowed Liberty's claim against NEGT and Liberty did not appeal. Indeed, at the risk of oversimplification, NEGT seems to be little more than a cheerleader for ET Power or a surrogate for GTN in this appeal. The real dispute, therefore, is only between the primary obligor and its creditor.

Liberty continued to assert its claim in bankruptcy against the debtors for the full $140 million, recognizing, however, that it could not collect more than the approximately $17 million needed to satisfy the debt. In Liberty's view, this $17 million represented principal for which the debtors remained jointly and severally liable, even though they had filed for bankruptcy. [1]

Proper analysis of Liberty's claim begins with the basic principle of contract law that Liberty is entitled to be paid in full, including interest, by its jointly and severally liable debtors. When one or more debtors file a bankruptcy petition, as here, it is undisputable that § 502(b)(2) bars a creditor from recovering interest not yet accrued as of the date of the bankruptcy petition against such a debtor. *See* Majority Op. at 301-03. However, it is also well-settled that § 502(b)(2) has no impact on the accrual of unmatured interest against non-debtors, including non-debtor guarantors. *See, e.g., Bruning v. United States*, 376 U.S. 358, 362 n. 4, 84 S.Ct. 906, 11 L.Ed.2d 772 (1964) (explaining that claims do not "los[e] their interest-bearing quality" in bankruptcy, but that post-petition interest is disallowed as a "rule of distribution"); *Kielisch v. Educ. Credit Mgmt Corp. (In re Kielisch)*, 258 F.3d 315, 323 (4th Cir.2001) ("Section 502 bars creditors from making *claims* from the bankruptcy estate for unmatured interest," but "does not purport to limit the *liability* on those claims, i.e., 'debts.' "); *In re El Paso Refining, Inc.*, 192 B.R. 144, 146 (Bankr.W.D.Tex.1996) (holding that § 502(b)(2) only

1. As the majority notes, only Liberty's claim against ET Power is at issue in this appeal.

bars "unmatured interest from becoming an allowed claim against the debtor's [bankruptcy] estate" and that "the obligation to pay interest vis-a-vis a guarantor is not tolled or eliminated by operation of section 502(b)(2)" (emphasis omitted)).

The majority intermingles these independent principles to arrive at its holding: that the $17 million that Liberty seeks to recover from ET Power represents "disallowed post-petition interest no matter how Liberty chooses to classify it." Majority Op. at 302. This approach, however, has the effect of limiting the non-debtor guarantor's liability for interest accruing after the debtor's bankruptcy petition. That is, the majority would have the bar to recovery of interest from the debtor swallow the accrual of interest on the debt across all parties liable for it. There is simply nothing in the Bankruptcy Code, applicable case law, the relevant guarantee agreement, or nonbankruptcy law to support the jettisoning of basic contract law principles in favor of an expansive reading of § 502(b)(2).[2]

---

2. The majority attempts to justify its result by invoking this court's duty to " 'sift the circumstances surrounding' the claim to determine the reality of the transaction for purposes of the bankruptcy proceeding." Majority Op. at 302 (citing *Smith v. Robinson*, 343 F.2d 793, 801 (4th Cir.1965)). There is no reason, however, to allow "sift[ing] the circumstances" to engulf even basic principles of contract law by restructuring the private contracts of non-debtors.

The majority also seeks to place the blame for Liberty's inability to collect the full amount of its debt on the guarantee

(Cont'd)

In fact, the majority's approach actually seems to run counter to another section of the Bankruptcy Code. Section 524(e) provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." *See also El Paso*, 192 B.R. at 146 (holding that § 524(e) mandated that the independent obligations of a guarantor were unaffected by the bankruptcy of the principal obligor); *Stoller's, Inc. v. Peoples Trust Bank (In re Stoller's, Inc.)*, 93 B.R. 628, 635-36 (Bankr.N.D. Ind.1998) (holding guarantors liable for post-petition interest). The majority's holding appears to expressly violate § 524(e) by allowing the bankruptcy filing of the debtors to dictate how Liberty accounts for its contractual payment from GTN, or, in other words, allowing the "discharge of a debt of the debtor [to] affect the liability of [GTN] on . . . such debt," § 524(e).

Furthermore, in contrast to the majority's contention, I do not believe that a creditor's receipt of payment from a non-debtor guarantor implicates either of the purposes of § 502(b)(2): (1) avoiding "unfairness as between competing creditors" and (2) minimizing the

---

(Cont'd)

itself, which caps GTN's liability at $140 million. *See id.* at 303 n. 5. If GTN's liability under the guarantee were unlimited, the majority apparently reasons, Liberty could collect the full value of its claim from GTN. As a matter of contract law, the majority is correct. But, as the bankruptcy court noted, "the cap [on GTN's liability in its contract with Liberty is] no impediment to Liberty's right to be paid in full from all sources" where the debtors are jointly and severally liable for the principal debt. *Nat'l Energy & Gas Transmission, Inc.*, No. 03-03104, at *8.

"administrative inconvenience" that repeated recomputation of interest requires, *Bruning*, 376 U.S. at 362, 84 S.Ct. 906. With respect to the first, I fail to see the unfairness in the fact that Liberty bargained, outside of bankruptcy, for a guarantee of payment. That other creditors may not have secured such a guarantee, and therefore might ultimately recover proportionally less than Liberty, strikes me as no injustice. Second, even the debtors do not argue that the bankruptcy court's order below would require burdensome recomputation of interest, as it specifies the allowed amount of Liberty's claim as determined in the arbitration proceeding.

Therefore, because neither bankruptcy law nor the contract governing Liberty's relationship with the non-debtor guarantor GTN limits Liberty's right to allocate its recovery from GTN in any manner that it wishes, I would affirm the district court.

APPENDIX B — FINAL ORDER OF JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND FILED MARCH 7, 2006

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

Civil No. PJM 05-2531

In re:

NATIONAL ENERGY &
GAS TRANSMISSION, INC., et al.,

Debtors.

NATIONAL ENERGY &
GAS TRANSMISSION, INC., et al.,

Plaintiffs,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant.

FINAL ORDER OF JUDGMENT

Upon consideration of National Energy & Gas Transmission, Inc., et al.'s Appeal of the Bankruptcy Court's Order of August 10, 2005 Granting 1) Motion to Confirm an Arbitration Award, and 2) Motion to Dismiss

Appendix B

Adversary Proceeding and Objection to Claims and for Related Relief; and Liberty Electric Power, LLC's Opposition thereto; it is for the reasons stated on the record this 6th day of March, 2006

ORDERED:

1) The Bankruptcy Court's Order of August 10, 2005 Granting 1) Motion to Confirm an Arbitration Award, and 2) Motion to Dismiss Adversary Proceeding and Objection to Claims and for Related Relief is AFFIRMED; and

2) The Clerk of Court SHALL CLOSE this case.

/s/
PETER J. MESSITTE
UNITED STATES DISTRICT JUDGE

APPENDIX C — ORDER OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MARYLAND, GREENBELT DIVISION FILED AUGUST 10, 2005

IN THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MARYLAND (Greenbelt Division)

Case No.: 03-30459 (PM) and 03-30461 (PM) through 03-30464 (PM)
Chapter 11
(Jointly Administered under Case No.: 03-30459 (PM))

Adversary Proceeding No.: 03-03104

In re:

NATIONAL ENERGY & GAS TRANSMISSION (f/k/a PG&E NATIONAL ENERGY GROUP, INC.), et al.,

Debtors.

NATIONAL ENERGY & GAS TRANSMISSION (f/k/a PG&E NATIONAL ENERGY GROUP, INC.), NEGT ENERGY TRADING L.P. (f/k/a PG&E ENERGY TRADING - POWER, L.P.), and GAS TRANSMISSION NORTHWEST CORPORATION,

Plaintiffs,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant.

Appendix C

ORDER GRANTING (I) MOTION TO CONFIRM AN ARBITRATION AWARD, AND (II) MOTION TO DISMISS ADVERSARY PROCEEDING AND OBJECTION TO CLAIMS AND FOR RELATED RELIEF

Upon consideration of: (i) the motion of Liberty Electric Power, LLC ("Liberty") for entry of an order confirming an arbitration award (the "Confirmation Motion"), and (ii) Liberty's motion for entry of an order dismissing with prejudice the above-captioned adversary proceeding (the "Adversary Proceeding") and the Debtors' Objection to Allowance of Claims Nos. 323 and 325 Filed by Liberty Electric Power, LLC (the "Claim Objection") and seeking related relief (the "Dismissal Motion" and together with the Confirmation Motion, the "Motions"),[1] and upon consideration of the objection filed by the Debtors and the other pleadings and papers of record herein, adequate and proper notice of the Motions having been given, and upon the record of the hearing held on May 12, 2005 and this court's Memorandum of Decision dated June 24, 2005, and for good cause shown, it is by the United States Bankruptcy Court for the District of Maryland, sitting in Greenbelt,

ORDERED, ADJUDGED AND DECREED as follows:

1. The Motions are granted and approved to the extent set forth herein.

---

1. Capitalized terms not otherwise defined herein have the meanings ascribed to them in the Motions.

2. The Award, a copy of which is annexed hereto as Exhibit A, is hereby confirmed.

3. The Clerk of the Court is directed to enter judgment confirming the Award against NEGT Energy Trading-Power, L.P. (f/k/a PG&E Energy Trading-Power, L.P.) ("ET Power") in the amount of $162,725,436.59 (the "Judgment Amount").[2]

4. The Adversary Proceeding is hereby dismissed with prejudice.

5. Claim number 323 filed by Liberty in the chapter 11 case of ET Power is hereby allowed as a general unsecured claim in the ET Power case in the amount of $145,428,046 (the "Allowed Claim"); *provided*, that the maximum amount of distribution payable to Liberty on account of the Allowed Claim shall be $22,725,436.59 (*i.e.*, the Judgment Amount less the $140 million payment from the GTN Escrow).

6. Liberty's claims for costs and legal fees are denied.

7. Claim number 325 filed by Liberty in the chapter 11 case of NEGT shall be expunged without further order of the Court. The Court-appointed claims agent for the Debtors is directed to amend the official claims register to reflect the expungement of such claim.

---

2. The Judgment Amount represents the aggregate of the principal amounts of the Award, the June Invoice and the July Invoice, plus accrued interest through the date of payment from the GTN Escrow.

8. This Court shall retain jurisdiction over all claims and matters between the Debtors and Liberty, including the matters contained in this Order.

END OF ORDER

APPENDIX D — MEMORANDUM OF DECISION OF THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF MARYLAND AT GREENBELT DATE SIGNED JUNE 24, 2005

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF MARYLAND
at Greenbelt

Case Nos. 03-30459PM; 03-30461PM
through 03-30464PM

Chapter 11

Jointly Administered under Case No. 03-30459PM

Adversary Proc. No. 03-03104

In re:

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E NATIONAL ENERGY GROUP, INC.), *et al.*,

Debtors.

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E NATIONAL ENERGY GROUP, INC.); NEGT ENERGY TRADING POWER - L.P. (f/k/a PG&E ENERGY TRADING - POWER, L.P.; and GAS TRANSMISSION NORTHWEST CORPORATION,

Plaintiffs,

v.

LIBERTY ELECTRIC POWER, LLC,

Defendant.

Appendix D

MEMORANDUM OF DECISION

Before the court are two motions of the defendant Liberty Electric Power, LLC ("Liberty"), a "Motion to Confirm an Arbitration Award" and a "Motion to Dismiss Adversary Proceeding and Objection to Claims, and for Related Relief" and the opposition thereto. This court has jurisdiction of this matter pursuant to 28 U.S.C. § 1334(a), 28 U.S.C. § 157(a) and Local Rule 402 of the United States District Court for the District of Maryland, referring all cases under Title 11 of the United States Code to the Bankruptcy Judges of this District. This is a core proceeding under 28 U.S.C. § 157(b)(2)(A) and (O).

Background

In April 2000, Liberty and NEGT Energy Trading-Power, L.P. (f/k/a PG&E Energy Trading-Power, L.P.) ("ET Power") entered into a Tolling Agreement that granted, among other things, ET Power first access to production capacity of Liberty's electric power generating facility. PG&E Gas Transmission, Northwest Corporation ("GTN") guaranteed ET Power's obligations in February, 2001. The guarantee was capped at $150,000,000 and later reduced to $140,000,000.

ET Power allegedly defaulted under the Tolling Agreement, resulting in unpaid invoices for June and July, 2003, totaling $5,428,045.82. On July 8, 2003, ET Power filed a bankruptcy case under chapter 11. ET Power's rejection of the Tolling Agreement was approved

by this court by order dated August 6, 2003 (amended by order dated August 11, 2003). The rejection resulted in a breach of the Tolling Agreement. Liberty sought payment of the unpaid invoices and a "Termination Payment" pursuant to § 14.2(a) of the Tolling Agreement from ET Power. Liberty also sought payment from GTN, the non-debtor guarantor.

When GTN did not honor the guarantee, Liberty filed an action in the United States District Court for the Southern District of Texas. Liberty also filed Proofs of Claim in both the ET Power and National Energy & Gas Transmission, Inc. (f/k/a PG&E National Energy Group, Inc.) ("NEGT") cases.[1] The claims were objected to by each debtor.

In September, 2003, plaintiffs commenced this adversary proceeding. Ultimately, the action against GTN was stayed and the dispute was arbitrated, resulting in an award in Liberty's favor and against ET Power.[2] In the arbitration proceeding, Liberty sought compensation for the Termination Payment, the unpaid invoice amounts, costs and fees and interest. The panel found that Liberty

---

1. Liberty asserted a general unsecured claim against ET Power in the amount of $182,198,749.90, plus additional amounts, and a general unsecured claim against NEGT in the amount of $140,000,000.

2. The arbitration proceeding was before the American Arbitration Association in the *Matter of Liberty Electric Power, LLC, Claimant, v. NEGT Electric Trading - Power, L.P., Respondent*, Case No. 70 198 Y 00228 04.

was entitled to a $140,000,000 Termination Payment, plus interest accruing from July 8, 2003, the stipulated date of breach. The panel declined to rule upon the accrual of interest on the unpaid and undisputed invoice amounts and concluded that each party was to bear its own costs.

Discussion

The arbitration award will be confirmed by this court in accordance with § 9 of the Federal Arbitration Act (9 U.S.C. § 1 *et. seq.*). Plaintiffs do not object to the entry of an order confirming the panel's award of $140,000,000. The court is informed that, in accordance with an order entered May 18, 2005, $140,000,000 was wired to Liberty on May 19, 2005, in full and final satisfaction of the GTN Guarantee.[3] However, there remains disputed issues for decision that do not involve confirmation of the award but ultimately affect the amounts of the judgment to be entered and the resolution of the contested matter.

(1) The Parties' Positions.

Liberty asserts that GTN is liable for *all* of the ET Power-guaranteed obligations under the Tolling Agreement, including costs and fees and interest, subject

---

3. In May, 2004, NEGT sold 100% of the GTN stock to TransCanada Corporation. The sale agreement required that a sum equal to the full amount of the GTN Guarantee be placed in an escrow account. Pursuant to the agreements executed at the time of sale, any liability of GTN to Liberty would be paid from this escrow.

to the $140,000,000 cap.[4] Liberty further contends that it may simultaneously assert claims against ET Power and NEGT, without any reduction for payment, until paid in full. It argues that it may apply the payment from GTN first to interest, then to costs and fees and lastly to principal and that plaintiffs do not have standing to direct application.

Plaintiffs' position is murkier but boils down to Liberty is entitled to *only* the payment of the Termination Payment and the unpaid invoice amounts. As to the undisputed invoice amounts, plaintiffs consented to the allowance of Liberty's claims (excluding interest) against NEGT and ET Power but, in a later responsive pleading, by footnote, reversed this position as to NEGT. As to the arbitration award, they take the position that since Liberty has been paid the $140,000,000 Termination Payment, there exists no further liability as to NEGT or ET Power – no postpetition interest owed pursuant to 11 U.S.C. § 502(b)(2) despite the arbitration panels' award and no chargeable costs and fees. Plaintiffs argue that once the amount of the GTN Guarantee cap has been paid, no further funds can be charged to GTN or, by virtue of the

---

4. Liberty sets forth ET Power's approximate liabilities as:

Principal - $140,000,000
Invoices - $5,400,000
Interest (on the Termination Payment and the unpaid invoice) - $16,800,000 Collection costs/fees - $3,700,000

NEGT Guarantee[5], to NEGT. Plaintiffs posit further assent that Liberty must apply the $140,000,000 guarantee payment first to principal.

(2) Postpetition Interest.

Liberty seeks $16,181,086 in interest from July 8, 2003 to March 30, 2005, on the Termination Payment, together with interest accruing at $33,162.00 per day. It also seeks $6,027,273 in interest through March 30, 2005, on the unpaid invoiced amounts, interest accruing at $238 per day. Whether Liberty is entitled to collect this interest from plaintiffs involves the interpretation of paragraphs 1 and 2 of the GTN Guarantee. Paragraphs 1 and 2 of the Guarantee state:

> 1. *Guarantee.* Subject the terms herein, the GTN Guarantor absolutely, unconditionally and irrevocably guarantees to the Guaranteed Party, its successors and assigns, as primary obligor and not merely as surety, the prompt payment when due, in accordance with the terms of the Agreement, of all amounts payable by

5. Plaintiffs assert that there is no basis for any claim against NEGT, citing to the NEGT Guarantee. NEGT's liability arose from its Guarantee, dated February 6, 2001. Plaintiffs argue that, pursuant to paragraph 2, NEGT's liability is reduced by any amounts paid by GTN under the GTN Guarantee – *i.e.*, once the $140,000,000 is paid by GTN, no further liability exists. Liberty asserts that pursuant to section 7 of the NEGT Guarantee, it may make a demand on NEGT for any obligations that remain unpaid, subject to the cap.

Affiliate under the Agreement and any amendments thereto, including without limitation, Tolling Fees, Termination Payment, liquidated damages, indemnity obligations, and damage awards arising by reason of Affiliate's breach of its performance obligations under the Agreement or otherwise (collectively, the "*Obligations*"). The obligation to make payments under this Guarantee is a guarantee of payment and not of collection. If Affiliate fails to pay any Obligation, GTN Guarantor will pay such Obligation directly for Guaranteed Party's benefit on the terms and subject to the conditions set forth in Section 7. Capitalized terms used and not defined herein shall have meaning given such terms in the Agreement.

2. *Extent of Liability & Term.* GTN Guarantor's liability under this Guarantee is limited to the aggregate of US$150,000,000, as reduced (I) pursuant to Section 8.1(b) of the Agreement and (ii) by any amounts paid by the NEG Guarantor pursuant to the NEG Guarantee and not returned to the NEG Guarantor by or on behalf of the Guaranteed Party (the "*Guarantee Cap*"). GTN Guarantor shall not be obligated to monitor the amount of Affiliate's Obligations to Guaranteed Party, and Guaranteed Party will bear the risk that the aggregate amount

> of the Obligations exceeds the Guarantee Cap and only payments made by GTN Guarantor pursuant to a demand for payment in accordance with Section 7 hereof shall reduce the amount of the Guarantee Cap. No payments will be made hereunder unless and until a Payment Demand has been issued by the Guaranteed Party in accordance with Section 7 hereof. Except as the same comprise Obligations under the Agreement, GTN Guarantor shall not be liable hereunder for special, consequential, exemplary, tort or other damages. GTN Guarantor agrees to pay all out-of-pocket expenses (including the reasonable fees and expenses of Guaranteed Party's counsel) incurred for the enforcement of the rights of Guaranteed Party hereunder; provided that GTN Guarantor shall not be liable for any such expenses if no payment under this Guarantee is due and such payments shall be subject to the Guarantee Cap.

Paragraph 1 of the GTN Guarantee provides Liberty with assurance that if ET Power fails to pay for any "Obligations" due under the Tolling Agreement, GTN will pay. These "Obligations" include interest under Section 14.2(a) of the Tolling Agreement. The GTN Guarantee merely limits GTN's liability to $140,000,000. It does not limit ET Power's liability under the Tolling Agreement. ET Power and NEGT (derivatively by virtue of its Guarantee) are liable to Liberty for interest.

Plaintiffs argue, nonetheless, that as an unsecured creditor, Liberty is not entitled to postpetition interest on its claims against ET Power and NEGT pursuant to 11 U.S.C. § 502(b)(2). Plaintiffs also allege that interest cannot be charged to GTN because the GTN Guarantee does not provide for interest – thereby limiting the liability of all parties to the $140,000,000 paid by GTN.

Liberty argues that GTN's obligation to pay interest is not tolled or eliminated by the application of 11 U.S.C. § 502(b)(2), asserting that its claim against a third party does not lose its interest-bearing quality during the postpetition period. Liberty maintains that application of 11 U.S.C. § 502(b)(2) would, in essence, grant the non-debtor GTN a discharge contrary to 11 U.S.C. § 524(e).

The court believes that the issue is one of novel impression and would be an ideal case for certification to the United States Court of Appeals for the Fourth Circuit pursuant to the revisions to 28 U.S.C. § 158(d)(2) made by § 1233 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (effective October 17, 2005). Nonetheless, 11 U.S.C. § 502(b)(2) provides:

> (b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim as of the date of the filing of the petition, and shall allow such claim in lawful currency of the United States in such amount, except to the extent that–

> (2) such claim is for unmatured interest.

Plaintiffs cite no authority for the proposition that a non-debtor guarantor is exempt from liability to pay interest accruing after the petition date of the debtor-primary obligor. They rely on what they term as an "analytically identical body of law" addressing recoveries on claims limited by 11 U.S.C. § 502(b)(6) and, by analogy, on the opinions of three courts.[6]

The court finds the analogy inappropriate. The limitation of 11 U.S.C. § 506(b)(6) on the amount that a landlord may recover on account of a rejected lease has long been a part of bankruptcy jurisprudence.

As noted in the Legislative History of the Bankruptcy Reform Act of 1978, this section is:

> [d]erived from current law, limits the damages allowable to a landlord of the debtor. The history of this provision is set out at length in *Oldden v. Tonto Realty Co.*, 143 F.3d 916 (CA2 1944). It is designed to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as

---

6. *Solow v. PPI Enters. (U.S.), Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197, 209 (CA3 2003); *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 300 (BAP CA9 2004); *see also SBTI Liquidating Trust v. EOP-Colonnade of Dallas, LP (In re Stonebridge Tech. Inc.)*, 291 B.R. 63, 70-72 (BC N.D. Tex. 2003).

to prevent other general unsecured creditors from recovering a dividend from the estate. The damages a landlord may assert from termination of a lease are limited to the rent reserved for the greater of one year or ten percent of the remaining lease term, not to exceed three years, after the earlier of the date of the filing of the petition and the date of surrender or repossession in a chapter 7 case and 3 years least payments in a chapter 9, 11, or 13 case. The sliding scale formula for chapter 7 cases is new and designed to protect the long-term lessor. This subsection does not apply to limit administrative expense claims for use of the leased premises to which the landlord is otherwise entitled.

This paragraph will not overrule *Oldden*, or the proposition for which it has been read to stand: to the extent that a landlord has a security deposit in excess of the amount of his claim allowed under this paragraph, the excess comes into the estate. Moreover, his allowed claim is for his total damages, as limited by this paragraph. By virtue of proposed 11 U.S.C. § 506(a) and § 506(d), the claim will be divided into a secured portion and an unsecured portion in those cases in which the deposit that the landlord holds is less than his damages. As under *Oldden*, he will not be permitted to offset his actual damages against his security deposit and then claim for the

> balance under this paragraph. Rather, his security deposit will be applied in satisfaction of the claim that is allowed under this paragraph.

S.Rep. 95-989, 63-64 (1978). However, 11 U.S.C. § 502(b)(2) is based upon entirely different reasoning. As Justice Black explains in *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 163-64 (1946), allowing interest would create a nightmare of continuous recomputation that is avoided by § 502(b)(2). *See In re Fesco Plastics Corp., Inc.*, 996 F.2d 152, 155 (CA7 1993).

The court finds that the *Oldden* doctrine carried into the Bankruptcy Reform Act of 1978 by § 506(b)(7), now § 506(b)(6), is not relevant to the current situation. The rationale of § 506(b)(6) found in most situations has no application here. The guarantee of GTN does not function as a security deposit and thus provide an "endrun" around § 502(b)(2) as described in *PPI Enterprises, Inc.*, 324 F.3d at 209 (No collateral of either NEGT or ET Power secures GTN. The payment of interest by GTN does not diminish this estate). The capping of recovery and application of security deposits for landlords is *sui generis*.[7]

---

7. The court is astounded that the International Council of Shopping Centers, perhaps Washington's most potent lobbyist on bankruptcy issues, was not able to improve its situation as to allow its absorption of security deposits, as it improved its position with respect to 11 U.S.C. § 365(d)(4) in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Here, the claim of Liberty against GTN, a jointly and severally liable non-debtor, suffers no limitation as that posited by Justice Black. GTN's obligation is to pay no more than the $140,000,000 cap. The court finds the cap no impediment to Liberty's right to be paid in full from all sources.

(3) Liberty's Costs and Fees.

Liberty seeks its fees and costs in connection with this action, totaling $3,656,113.06 through February, 2005. Plaintiffs' argue that Liberty incurred costs in enforcing the Tolling Agreement and not the GTN Guarantee and that the GTN Guarantee allows costs only for expenses incurred for the enforcement of the GTN Guarantee. Further, plaintiffs note that the arbitration panel specifically held that each party to the Tolling Agreement shall bear their own costs. The court finds that the costs and fees incurred by Liberty were not in enforcing the GTN Guarantee, but in enforcing the Tolling Agreement. Accordingly, Liberty is not entitled to its costs and fees.

(4) Plaintiffs' Standing to Direct Application of Payments Under the GTN Guaranty.

This court holds that, absent an agreement to the contrary, Liberty may apply the funds in a manner that it finds commercially reasonable.

Counsel for Liberty is directed to submit an appropriate order confirming the arbitration award and dismissing this adversary proceeding, an appropriate judgment and an appropriate order dispensing of the contested matter consistent with this Memorandum.

APPENDIX E — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT DENYING PETITION FOR REHEARING FILED AUGUST 6, 2007

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 06-1459
8:05-CV-02531-PJM
03-30459
AP 03-03104

In Re: NATIONAL ENERGY & GAS TRANSMISSION, INCORPORATED, formerly known as PG&E National Energy Group LLC

Debtor

NATIONAL ENERGY & GAS TRANSMISSION, INC. (f/k/a PG&E National Energy Group, Inc.); NEGT ENERGY TRADING POWER, L.P., (f/k/a PG&E Energy Trading Power, L.P.)

Plaintiffs - Appellants

and

GAS TRANSMISSION NORTHWEST CORPORATION

Plaintiff

v.

LIBERTY ELECTRIC POWER, LLC;

Defendant - Appellee

JOHN L. DAUGHERTY, Trustee

Trustee - Appellee

Appendix E

On Petition for Rehearing and Rehearing En Banc

Appellees filed a petition for rehearing and rehearing en banc.

Judge Duncan voted to grant panel rehearing. Judges Shedd and Wilson voted to deny.

No member of the Court requested a poll on the petition for rehearing en banc.

The Court denies the petition for rehearing and rehearing en banc.

Entered at the direction of Judge Shedd for the Court.

For the Court,
/s/ Patricia S. Connor
CLERK